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Analysis

Fixing China's current account surplus

Yiping Huang

China's current account surplus has been the subject of fierce debate in recent times, with politicians in the United States and Western Europe often criticising China's rigid exchange rate regime. The argument runs that, by artificially depressing the value of the renminbi (RMB), China took jobs away from its trading partners.

Rapid growth in China's current account surplus is, in fact, a relatively recent phenomenon. During the second half of the 1980s, China maintained persistent trade and current account deficits. The sharpest rise in current account surplus occurred after 2004. Within three years, the surpluses jumped from 3.5 per cent of GDP in 2004 to 10.8 per cent in 2007. In 2008, external demand was severely cut by the global crisis. But China's current account surplus still stood at 9.6 per cent of GDP.

What are the fundamental factors contributing to China's growing current account surpluses? Previous explanations may be grouped into five broad categories, these being: measurement errors; the saving and investment gap; industry relocation; policies promoting growth and exchange rate distortion.

All these explanations are related to understanding China's growing external imbalance problem. But none really explains it completely.

The core of the problem in the real

economy is factor market distortions that result from China's asymmetric market liberalization approach.

During the reform period, the government focused on reform of the product markets, including abandoning policy interventions in domestic markets and liberalizing trade in goods and services. Today, the prices of more than 95 per cent of products are determined by free market forces.

In contrast, factor markets remain highly distorted.

China is known for the low cost and abundance of its labour, which has been a key factor behind China's success in labour-intensive manufacturing exports. But labour costs in China may be distorted, for two reasons – segmentation of rural and urban labour markets and under-development of social welfare systems.

Distortions in capital markets exist at two levels. Domestically, the financial system remains repressed, evidenced by highly regulated interest rates and state influences on credit allocation. Externally, capital account controls are more restrictive on outflows than on inflows. The currency is likely undervalued, and has probably been so for the past 15 years.

China's financial system remains overly dependent on banks, especially the large state-owned commercial banks (SOCBs).

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Despite numerous reforms, giving banks more flexibility in determining the actual rates, the People's Bank of China (PBOC) still maintains floors for lending rates and ceilings for deposit rates.

The larger gap between nominal GDP growth potential and long-term government bond yields in China, relative to the gaps in other Asian economies, also suggests that China's capital is far too cheap. Compared with other Asian economies, China's nominal growth potential is among the highest, but its Treasury yield is among the lowest.

The price of key energy products, such as oil, gas and electricity, are also regulated by the state. For instance, when oil prices peaked at nearly \$150 per barrel in 2008, the corresponding domestic prices were only around \$80.

China has introduced a series of environmental laws and regulations. However, they have not been well-enforced.

Cost distortions in the above five categories add up to RMB2,138 billion in 2008, or 7.2 per cent of GDP. Producers in China receive significant 'subsidies' from the rest of the economy, equivalent to about 7 per cent of GDP or 15 per cent of industrial GDP.

This lowers input costs, increases production profits, raises investment returns and improves international competitiveness of the Chinese exports. It makes China growth very strong, averaging 10 per cent a year during the past thirty years. But it makes investment and exports even stronger.

Meanwhile, producer subsidy equivalents depress household income. Total labour compensation dropped from 52 per cent of GDP in 1997 to only 40 per cent in 2007.

If household income share in GDP declines over time, consumption growth would not be able to keep up pace with GDP growth.

While exchange rate policy is important it is not only, and perhaps not, the most important part of the story. Exclusive focus on the exchange rate policy issue is not likely to be able to deal with the imbalance problem, economically or politically.

The factor market distortion hypothesis not only satisfactorily explains the imbalance, but also provides a clear set of policies for remedying the problem of liberalizing the factor markets. These should include the abolition of the Household Registration System, better enforcement of employers' social welfare contribution, the introduction of market-based interest rates, an increase in exchange rate flexibility (only as one of the measures), the liberalization of both land and energy markets, and the rigorous implementation of environmental protection policies.

China's large external sector imbalance is a product of incomplete economic reform. The best way to reduce the imbalance is to finish the task of economic reform. The growing risks, including large current account surpluses, suggest that liberalizing factor markets should now be placed at the top of Chinese policymakers' agenda.

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